[JOINT COMMITTEE PRINT]

DESCRIPTION OF H.R. 2110 RELATING TO TECHNICAL CHANGES TO THE RETIREMENT EQUITY ACT OF 1984

SCHEDULED FOR A HEARING

BEFORE THE

COMMITTEE ON WAYS AND MEANS

ON MAY 16, 1985

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The House Committee on Ways and Means has scheduled a public hearing on May 16, 1985, on H.R. 2110 (introduced by Messrs. Rostenkowski, Duncan, and Clay, and Mrs. Roukema). H.R. 2110 would make technical changes to the Retirement Equity Act of 1984, P.L. 98-397 (hereinafter, "the Act"), and was referred jointly to the Committee on Ways and Means and the Committee on Education and Labor.

This pamphlet,[1] prepared in connection with the hearing, provides a detailed description of the provisions of the bill, including present law and effective dates.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Description of H.R. 2110 Relating to Technical Changes to the Retirement Equity Act of 1984* (JCS-14-85), May 14, 1985.

DESCRIPTION OF THE BILL

A. Minimum Participation, Vesting, and Benefit Accrual Standards (sec. 2(a) of the bill, sec. 203(c) of ERISA, and secs. 402 and 411 of the Code)

If a pension, profit-sharing, or stock bonus plan qualifies under the tax law,[2] then (1) a trust under the plan generally is exempt from Federal income tax, (2) employers are generally allowed deductions (within limits) for plan contributions for the year for which the contributions are made, even though participants are not taxed on plan benefits until the benefits are distributed, (3) benefits distributed as a lump sum distribution are eligible for special long-term capital gain or 10-year income averaging treatment, and (4) certain plan distributions may be rolled over, tax-free, to an individual retirement account (IRA) or to another qualified plan.

Under a pension plan (including a profit-sharing or stock bonus plan), benefits are provided to plan participants under formulas that determine the benefit a participant may earn, the portion of that benefit that has been earned, and the portion of the earned benefit that is nonforfeitable. Accordingly, such plans provide rules for determining whether an employee is a plan participant (the participation rules), for determining the portion of the benefit that has been earned (the benefit accrual rules), and for determining the nonforfeitable percentage of a participant's benefit (the vesting schedule).

Under present law, a pension plan must satisfy certain minimum standards relating to the conditions under which employees may be excluded from plan participation, to the formula under which plan benefits are accrued, and to the vesting schedule. The participation standards limit exclusions based on the age and period of service completed by an employee.[3] The benefit accrual standards are based upon the number of years of plan participation. The vesting standard generally is based upon the number of years of service with the employer completed by the employee.

1. Break-in-service rules

Present Law

In general, all years of service with the employer maintaining a pension plan are taken into account for purposes of counting the number of years of plan participation. No credit need be provided, however, for periods during which an employee is considered to have a break in service. In some cases, an employee who returns to

[2] Sec. 401(a) of the Internal Revenue Code of 1954 (the Code).

[3] In addition, the Code provides participation rules for qualified plans. These rules are designed to require that qualified plans provide participation to a broad cross-section of employees.

work for an employer after a break in service may lose credit for pre-break service.

Pension plans often provide deferred vesting with respect to benefits derived from employer contributions. In general, all years of service with the employer maintaining a plan are taken into account in determining the level of an employee's vested benefits.

In the case of a nonvested participant, years of service with the employer or employers maintaining the plan before any period of consecutive one-year breaks in service are required to be taken into account after a break in service unless the number of consecutive one-year breaks in service equals or exceeds the greater of (1) five years, or (2) the aggregate number of years of service before the consecutive one-year breaks in service.

In addition, in the case of a participant in a defined contribution plan or in a defined benefit pension plan funded solely by certain insurance contracts, years of service after a break in service are counted for purposes of determining the vested percentage of the participant's accrued benefit derived from employer contributions before the break in service, unless the participant incurs at least five consecutive one-year breaks in service.

In a class-year plan, employees' rights to benefits attributable to contributions made on their behalf with respect to any plan year are nonforfeitable not later than the close of the fifth plan year following the plan year for which the contributions were made.

The Act did not explicitly conform the expanded break-in-service rules with the rules regarding the taxation of lump sum distributions. Thus, if an employee separates from service, and receives a distribution prior to the time at which five consecutive one-year breaks in service are incurred, the potential increase in vesting that might occur if the employee returned to service may make the distribution ineligible for special 10-year income averaging tax treatment (sec. 402(e)).

Explanation of Provision

Effective generally for contributions made for plan years beginning after the date of enactment of the bill, the break-in-service standards of the Code and ERISA applicable to class-year plans are to be conformed to the break-in-service rules provided for other types of plans. Under the bill, a class-year plan generally is to provide that 100 percent of each participating employee's right to benefits derived from employer contributions for a plan year (the contribution year) is to be nonforfeitable as of the close of the fifth plan year of service (whether or not consecutive) with the employer following the contribution year. Under the bill, a plan year is a plan year of service with the employer if the participant has not separated from service with the employer as of the close of that year.

The bill provides that if a participant incurs five consecutive one-year breaks in service before the completion of five plan years of service with respect to a contribution year, then the plan may provide that the participant forfeits any right to benefits derived from the employer contributions for the contribution year.

In addition, the bill conforms the rules regarding the taxation of lump sum distributions to the break-in-service rules. Under the bill, in determining whether any distribution payable on account of separation from service is a lump sum distribution, the balance to the credit of the employee is to be determined without taking into account any increase in vesting that could occur if the employee is reemployed by the employer. Under the bill, however, if the employee is actually reemployed by the employer and the nonforfeitable interest of the employee in the amount of the pre-break accrued benefit is thereby increased, then the reduction in tax attributable to the treatment of the distribution as a lump sum distribution is to be recaptured as provided by Treasury regulations.

The bill conforms the rules relating to the withdrawal of mandatory employee contributions to the changes made by the Act to the break in service rules. Thus, under the bill, in the case of a defined contribution plan, the plan may provide that an account balance will not be restored unless the participant repays withdrawn mandatory contributions before the participant has five consecutive one-year breaks in service following the withdrawal.

2. Maximum age requirement

Present Law

The Act reduced from 25 to 21 the maximum age requirement that a pension plan may impose as a condition of plan participation. Thus, under the Act, a pension plan generally may not require, as a condition of participation, completion of more than one year of service or attainment of an age greater than 21 (whichever occurs later). The Act did not lower the maximum age requirement applicable to simplified employee pensions (SEPs).

Explanation of Provision

The bill reduces from 25 to 21 the maximum age requirement that a SEP may impose as a condition of plan participation. Thus, a SEP may not require, as a condition of participation, attainment of an age greater than 21 or the performance of services for more than three of the immediately preceding five calendar years (whichever occurs later).

B. Survivor Benefit Requirements (sec. 2(b) of the bill, sec. 205 of ERISA, and secs. 401 and 417 of the Code)

1. Coordination between qualified joint and survivor annuity and qualified preretirement survivor annuity

Present Law

A pension plan (including certain profit-sharing or stock bonus plans) is required generally to provide automatic survivor benefits with respect to an employee who was a participant in the plan if the participant's spouse survives the participant. In the case of a participant who retires under the plan, the survivor benefit is to be provided in the form of a qualified joint and survivor annuity. In the case of a vested participant who dies before the annuity start-

ing date (the first period for which an amount is received as an annuity, whether by reason of death or disability, under the plan), the survivor benefit is to be provided in the form of a qualified preretirement survivor annuity.

A vested participant is any participant (whether or not still employed by the employer at the time of death) who has a nonforfeitable right to any portion of the accrued benefit under the plan derived from employer contributions. If a plan permits a surviving spouse to elect to have survivor benefits paid in a form other than an annuity, then the value of the alternative form of benefits is not to be less than the actuarial equivalent of the required survivor benefit.

Explanation of Provision

The bill provides that a qualified joint and survivor annuity is to be provided in the case of a married participant who does not die before the annuity starting date unless the benefit is waived (with spousal consent) in favor of another benefit. As under present law, the annuity starting date is the date on which an amount is first received as an annuity (whether or not the annuity is a life annuity). Accordingly, under the bill, the qualified preretirement survivor annuity rules apply in the case of death before the annuity starting date and the qualified joint and survivor annuity rules apply in the case of death on or after the annuity starting date.

Under the bill, if a participant dies before an amount is received as an annuity, the participant's spouse generally is entitled to a qualified preretirement survivor annuity unless that benefit has been waived. For example, if a participant receives an in-service distribution from a profit-sharing plan that is otherwise subject to the survivor benefit requirements, the amount received is not treated as an amount received as an annuity.

Similarly, under the bill, if a participant dies after attaining the normal retirement age under a plan but before the annuity starting date, a qualified preretirement survivor benefit is to be provided to the participant's spouse unless the benefit has been waived.

2. Transferee plan rules

Present Law

The provisions requiring survivor benefits generally apply to any pension plan. However, the survivor benefit requirements do not apply with respect to a participant under a profit-sharing or stock bonus plan if (1) the plan provides that the nonforfeitable accrued benefits of a deceased participant will be paid to the surviving spouse of the participant (or to another beneficiary if the surviving spouse consents or if there is no surviving spouse), (2) under a plan that provides for benefits in the form of a life annuity, the participant does not elect payment of benefits in the form of a life annuity, and (3) with respect to the participant, the plan is not a direct or indirect transferee of a plan required to provide survivor benefits. A plan is a transferee of a plan required to provide survivor benefits if the plan (1) receives a direct transfer of assets in connection with a merger, spinoff, or conversion of a plan that is subject

to the survivor benefit requirements, or (2) receives a direct transfer of assets solely with respect to the participant. Also, a plan is a transferee plan with respect to a participant if it receives amounts from a plan that is a transferee plan with respect to that participant. A plan is not a transferee plan merely because it receives a rollover contribution by a participant in another plan.

Explanation of Provision

The bill includes two provisions relating to the transferee plan rules. First, the bill clarifies that a plan is not to be considered a transferee plan on account of a transfer made before January 1, 1985. Accordingly, a plan would not be treated as a transferee merely because of a transfer completed before January 1, 1985.

In addition, the bill clarifies that if separate accounts are properly maintained for the transferred assets and investment yield attributable to those assets, then the transferee plan rule applies only with respect to benefits attributable to the transferred assets. Under the bill, if separate accounts are not maintained for transferred assets with respect to an employee, then the survivor benefit requirements apply to all benefits payable with respect to the employee under the plan.

3. Qualified preretirement survivor annuity in case of terminated vested participant

Present Law

A qualified preretirement survivor annuity is defined as an annuity for the life of the surviving spouse of the participant. The amount of each payment under a qualified preretirement survivor annuity is not to be less than the payment that would have been made under a qualified joint and survivor annuity if (1) in the case of a participant who dies after attaining the earliest retirement age under the plan, the participant had retired with an immediate qualified joint and survivor annuity on the day before the participant's death, and (2) in the case of a participant who dies on or before the earliest retirement age under the plan, the participant had separated from service on the date of death, survived until the earliest retirement age, and retired at that time with a qualified joint and survivor annuity.

Explanation of Provision

The bill clarifies that, in the case of a participant who separates from service prior to death, the amount of the qualified preretirement survivor annuity is to be calculated by reference to the actual date of separation from service, rather than the date of death. Thus, for purposes of calculating the qualified preretirement survivor annuity, a participant is not to be considered to accrue benefits after the date of separation from service.

4. Spousal consent requirements

Present Law

Under present law, the consent of a participant's spouse is required for an election to waive the qualified joint and survivor annuity or the qualified preretirement survivor annuity. This consent is to be given in writing at the time of the participant's election, and the consent is to acknowledge the effect of the election. A consent is not valid unless it is witnessed by a plan representative or a notary public. Any consent obtained is effective only with respect to the spouse who signs it.

A spouse's consent to waive a death benefit under a profit-sharing or stock bonus plan not otherwise subject to the survivor benefit requirements is to be made in the same manner as the spousal consent to waive a qualified joint and survivor annuity or a qualified preretirement survivor annuity. The Act does not require the spousal consent under an exempt profit-sharing or stock bonus plan to be made at the same time as spousal consent under a plan subject to the survivor benefit requirements. Thus, the Act generally does not require that spousal consent be obtained to make a distribution (other than the payment of benefits in the form of a life annuity) to a participant under a profit-sharing or stock bonus plan.

A plan may immediately distribute the present value of the benefit under either the qualified joint and survivor annuity or the qualified preretirement survivor annuity if the present value of the benefit does not exceed $3,500. No distribution may be made after the annuity starting date unless the participant and the participant's spouse (or the surviving spouse of the participant) consent in writing to the distribution. Thus, a plan could permit a participant and the participant's spouse to change the form of benefits received under the plan after the annuity starting date.

In addition, if the present value of the benefit under the qualified joint and survivor annuity or the qualified preretirement survivor annuity exceeds $3,500, then the consent of the participant and spouse (or the surviving spouse if the participant has died) must be obtained before the plan can immediately distribute any part of the present value.

Present law does not preclude a plan from permitting a spouse to make a conditional waiver of a survivor benefit. For example, a plan could offer a spouse the right to waive a qualified preretirement survivor annuity, effective only if the present value of the annuity is less than another death benefit payable to the spouse under the plan.

Explanation of Provision

Under the bill, a spouse's consent to waive a qualified joint and survivor annuity or a qualified preretirement survivor annuity is not valid unless the consent (1) names a designated beneficiary who will receive any survivor benefits under the plan or (2) acknowledges that the spouse has the right to limit consent only to a specific beneficiary and the spouse voluntarily elects to relinquish such right. The spousal consent form is to contain such information

as may be appropriate to disclose to the spouse the rights that are relinquished. If the consent names a designated beneficiary, then any subsequent change to the beneficiary designation is invalid unless a new consent is obtained from the participant's spouse. A plan that permits a waiver by the spouse may not restrict the spouse's ability to waive by requiring that any such waiver not designate a specific beneficiary.

Similar rules apply to a spousal consent obtained to waive a death benefit under a profit-sharing or stock bonus plan that is not otherwise subject to the survivor benefit requirements.

In addition, under the bill, in the case of a participant's benefit that is not exempt from the survivor benefit requirements, a plan is to provide that no portion of the accrued benefit of the participant may be used as security for any loan unless the participant's spouse (determined at the time of the loan) consents to the use of the accrued benefit as security. If the spouse gives consent, then the plan is not prevented by the spousal consent rules from realizing its security interest in the event of a default on the participant's loan.

The consent of a spouse in writing to a loan under the plan is to be made in the same manner as spousal consent to waive a survivor benefit. However, such consent is not subject to the usual rules for the timing of spousal consent.

For example, assume that a spouse consents to a pledge of the participant's account balance as security for a loan from the plan. Under the plan, the plan administrator is to realize on the security for the loan if it is not repaid by the time the employee separates from service. Because the spouse consented to the loan, the plan is not prevented from using the security (i.e., the account balance) to recover the amount due on the loan. In addition, if the participant had remarried after the loan was made but before the plan realized on its security, then the consent of the earlier spouse would continue to be effective for purposes of determining the plan's ability to realize its security interest.

Effective Dates

The provision relating to spousal consents to beneficiary designations is effective for consents given after the date of enactment of the bill.

The provision relating to accrued benefits pledged as security for a loan is effective for loans made after April 18, 1985. In addition, any accrued benefits pledged as security for a loan prior to April 19, 1985, are exempt from the requirement that spousal consent be obtained. Accordingly, in the case of a pledge made before April 18, 1985, a plan is not required to obtain the consent of any spouse of a participant before it applies the benefit against the loan. Finally, any loan that is revised, extended, renewed, or renegotiated after April 18, 1985, is treated as a loan made (and security pledged) after April 18, 1985.

5. Notice requirement for individuals hired after age 35

Present Law

A plan is required to notify participants of their rights to decline a qualified preretirement survivor annuity before the applicable election period. This notice is to be provided within the period beginning on the first day of the plan year in which the participant attains age 32 and ending with the close of the plan year in which the participant attains age 35. This notice is to be comparable to the notice required with respect to the qualified joint and survivor annuity. The qualified preretirement survivor benefit coverage may become automatic prior to the time that the participant is entitled to decline such coverage.

Explanation of Provision

The bill provides that the period for giving notice to a participant who is hired after age 35 is a reasonable period after the date of hire. Treasury regulations could permit a reasonable period of time to include a period up to the later to occur of (1) the time the participant vests in any accrued benefits derived from employer contributions under the plan or (2) the expiration of 3 years after the participant's date of hire.

C. Qualified Domestic Relations Orders (sec. 2(c) of the bill, sec. 206 of ERISA, and secs. 502 and 414(p) of the Code)

Under present law, neither ERISA nor the Code treats a qualified domestic relations order as a prohibited assignment or alienation of benefits under a pension plan. In addition, the Act creates an exception to the ERISA preemption provision only with respect to these orders.

A "qualified domestic relations order" is a domestic relations order that (1) creates or recognizes the existence of an alternate payee's right to, or assigns to an alternate payee the right to, receive all or a portion of the benefits payable with respect to a participant under a pension plan, and (2) meets certain other requirements. A domestic relations order is any judgment, decree, or order (including approval of a property settlement agreement) that relates to the provision of child support, alimony payments, or marital property rights to a spouse, former spouse, child, or other dependent of the participant, and is made pursuant to a State domestic relations law (including community property law). An alternate payee includes any spouse, former spouse, child, or other dependent of a participant who is recognized by a qualified domestic relations order as having a right to receive all, or a portion of, the benefits payable under a plan with respect to the participant.

1. Tax treatment of divorce distributions

Present Law

Special rules are provided for determining the tax treatment of benefits subject to a qualified domestic relations order. For purposes of determining the taxability of benefits, the alternate payee

is treated as a distributee with respect to payments received from or under a plan.

In addition, net employee contributions (together with other amounts treated as the participant's investment in the contract) are apportioned between the participant and the alternate payee under regulations prescribed by the Secretary of the Treasury.

Explanation of Provision

The bill provides that the special rules for determining the taxability of benefits subject to a qualified domestic relations order apply only to distributions made to an alternate payee who is the spouse or the former spouse of the participant. Thus, distributions to a spouse or former spouse generally will be included in the gross income of the spouse or former spouse. Under the bill, however, a distribution to an alternate payee other than a spouse (e.g., a child) is generally to be includible in the gross income of the participant.

2. Determination by plan administrator

Present Law

The administrator of a plan that receives a domestic relations order is required to notify promptly the participant and any other alternate payee of receipt of the order and of the plan's procedures for determining whether the order is qualified. In addition, within a reasonable period after receipt of the order, the plan administrator is to determine whether the order is qualified and notify the participant and alternate payee of the determination.

During any period in which the issue of whether an order is a qualified order is being determined (by the plan administrator, by a court of competent jurisdiction, or otherwise), the plan administrator is to defer the payment of any benefits in dispute. These deferred benefits are segregated either in a separate account in the plan or in an escrow account.

If the order is determined to be a qualified domestic relations order within 18 months after benefits are first deferred, then the plan administrator is to pay the segregated amounts to the persons entitled to receive them. If the plan administrator determines that the order is not a qualified order or, after the 18-month period has expired, has not resolved the issue of whether the order is qualified, then the segregated amounts are paid to the person or persons who would have received the amounts if the order had not been issued.

Explanation of Provision

The bill makes it clear that the 18-month period during which benefits may be deferred begins with the date on which any payments would, but for the deferral, be required to commence. Accordingly, if a payment is deferred pending the resolution of a dispute, then that payment and each other payment that is deferred within the next 18 months because of the dispute are to be segregated. If the dispute is not resolved 18 months after the first payment is deferred, then all payments deferred during the 18-month

period with respect to the dispute are to be paid to the persons who would have received them if the order had not been issued.

3. Coordination with qualified plan requirements

Present Law

A plan is not treated as failing to satisfy the requirements of section 401(a) or 401(k) of the Internal Revenue Code that prohibit payment of benefits prior to termination of employment solely because the plan makes payments to the alternate payee in accordance with a qualified domestic relations order. However, it is unclear whether payments made to an alternate payee pursuant to a qualified domestic relations order prior to the date at which the participant would have attained the earliest retirement age would violate these qualification requirements.

Explanation of Provision

The bill makes it clear that a plan is not treated as failing to satisfy the qualification requirements of section 401(a) or 401(k) of the Internal Revenue Code (prohibiting payment of benefits prior to termination of employment) solely because the plan makes payment to the alternate payee, even if the payments are made with respect to a participant who has not separated from service, and they commence before the participant has attained the earliest retirement age under the plan. This exception applies, however, only if the present value of the benefit to be paid to an alternate payee does not exceed $3,500.

In addition, the bill authorizes the Secretary of the Treasury to issue such regulations as may be necessary to otherwise coordinate the Code provisions affecting qualified domestic relations orders (secs. 401(a)(13)(B) and 414(p)), and the regulations issued by the Secretary of Labor thereunder, with other Code provisions affecting qualified plans. The Secretary of Labor has authority to issue regulations under the qualified domestic relations order provisions of ERISA, and the Code (secs. 401(a)(13)(B) and 414(p)), and the bill does not affect the authority of the Secretary of Labor to prescribe such regulations.

D. Notice of Rollover Treatment (sec. 2(d) of the bill and secs. 402 and 6652 of the Code)

Present Law

When the administrator of a qualified plan makes a qualifying rollover distribution, the administrator is to provide notice to the recipient that (1) the distribution will not be taxed currently to the extent transferred to another qualified plan or an IRA, and (2) the transfer must be made within 60 days of receipt in order to qualify for this tax-free rollover treatment.

Failure of the plan administrator to give the required notice of rollover treatment results in imposition of a $10 penalty for each failure (up to $5,000) for each calendar year. This penalty does not apply if the failure is shown to be due to reasonable cause and not to willful neglect.

Explanation of Provision

The bill makes it clear that a plan administrator is to provide notice when making any distribution eligible for rollover treatment. Thus, for example, notice is to be provided when a distribution eligible for rollover treatment pursuant to the partial rollover rules is made.

E. Transitional Rules

Present Law

The qualified joint and survivor annuity and qualified preretirement survivor annuity provisions added by the Act generally are effective for plan years beginning after December 31, 1984.

The new rules for qualified joint and survivor benefits and preretirement survivor benefits apply to any participant who performs at least one hour of service or has at least one hour of paid leave under the plan on or after the date of enactment. In addition, a qualified preretirement survivor annuity must be provided (unless another form of benefit is elected) in the case of any participant who (1) performs at least one hour of service or has at least one hour of paid leave under the plan after August 23, 1984, (2) dies before the annuity starting date, and (3) dies before the first day of the first plan year to which the provisions apply.

The Act immediately imposes certain survivor benefit requirements with respect to participants who die before the plan is required to be amended to comply with the Act. During this transition period, it appears that a plan is required to make payments to a surviving spouse notwithstanding the possible contractual claims of other designated beneficiaries. However, it is unclear whether the survivor benefits required by the Act reduce the total death benefits payable to other designated beneficiaries.

Explanation of Provision

The bill clarifies the application of the transitional rule relating to qualified pre-retirement survivor benefits in situations in which the participant had designated a beneficiary other than the participant's spouse. Under the bill, the total death benefit payable to any beneficiary with respect to an individual who (1) performs at least one hour of service or has at least one hour of paid leave under the plan after August 23, 1984, (2) dies before the annuity starting date, and (3) dies before the first day of the first plan year to which the provisions apply, may be reduced by the amount payable to the participant's surviving spouse pursuant to the transition rule.

However, the bill also permits the surviving spouse to waive the right to receive the death benefit. Under the bill, if a waiver is made on or before the close of the first plan year to which the Act applies, then the waiver is not to be treated as a transfer for purposes of Federal gift taxes or as a prohibited assignment or alienation for purposes of ERISA or the Code. In addition, death benefits waived by the surviving spouse during this period would not be includible in the spouse's income. Such benefits would be includible in the gross income of the recipient.